Unofficial translation

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CIRCULAR LETTER

to

ALL COMMERCIAL BANKS

CONDUCTING CONVENTIONAL BUSINESS

IN INDONESIA

Subject: Asset Quality Rating for Commercial Banks

In reference to the issuance of Bank Indonesia Regulation Number 7/2/PBI/2005 dated January 20, 2005, concerning Asset Quality Rating for Commercial Banks (State Gazette of the Republic of Indonesia Number 12, Supplement to the State Gazette of the Republic of Indonesia Number 4471), it is necessary to stipulate implementation provisions in a Circular Letter of Bank Indonesia with key provisions as follows:

I. GENERAL REVIEW

1. In line with the increasing complexity in business and risk profile, it is essential for Banks to take measures including but not limited to the strengthening of Bank capacity and effectiveness in managing credit risk and minimizing potential loss from provision of funds to ensure the survival of their business.
2. Classification of credit quality is the result of assessment of factors influencing debtor condition and performance, namely prospects, debtor performance, and repayment capability. In assessing prospects, Banks need to take account of actions pursued by debtors to conserve the environment.
3. In view of the widely varying economic conditions in individual regions in Indonesia, it is deemed necessary to stipulate special treatment with easier requirements for assessment of credit and other provision of funds (comprising issuance of guarantees or opening of letters of credit) to debtors whose businesses are located in specified regions. Special treatment also needs to be extended to promote economic growth in these regions.
4. As one measure to minimize potential loss from problem debtors, Banks may conduct debt restructuring in regard to debtors that retain business prospects and repayment capability. Debt restructuring is expected to enable debtor businesses to survive and remain in

business ….

business. In this regard, debt restructuring needs to be conducted with due regard for the applicable prudential principles and accounting principles.

II. CREDIT QUALITY

1. Classification of Credit Quality

   a. The factors that must be taken into account in classification of credit quality are:

      1) Prospects

         Assessment of prospects shall be based on assessment of the following components:

         a) Potential for growth;
         b) market conditions and position of debtor relative to the competition;
         c) management quality and labor problems;
         d) support from the corporate group or affiliates; and
         e) measures taken by the debtor to conserve the environment.

      2) Debtor performance

         Assessment of debtor performance shall be based on assessment of the following components:

         a) earnings;
         b) capital structure;

c) cash ….

c) cash flow; and

d) sensitivity to market risk.

3) Repayment capability

Assessment of repayment capability shall be based on assessment of the following components:

a) promptness in repayment of principal and interest;

b) availability and accuracy of financial information on the debtor;

c) completeness of credit documentation;

d) compliance with the credit agreement;

e) appropriateness of use of funds; and

f) viability of sources for payment of obligations.

b. Criteria for each of the components referred to in letter a are described in Appendix I to this Circular Letter of Bank Indonesia.

c. Classification of credit quality shall take into account the materiality and significance of each assessment factor and component and the relevance of the assessment factors and components to the characteristics of the debtor concerned.

d. Thereafter, based on the assessment in letter b and letter c, credit quality shall be classified Current, Special Mention, Sub-standard, Doubtful, or Loss.

2. Environmental Management

   a. One of the criteria in assessment of prospects concerns the measures taken by the debtor to manage the environment, particularly in regard to large-scale debtors with major impact on the environment. This is consistent with the Elucidation to Article 8 of Act Number 7 of 1992 concerning Banking as amended by Act Number 10 of 1998, which states among others that one of the matters that needs to be taken into account in extending provision of funds is the Environmental Impact Assessment (EIA) for large-scale or high risk companies. The EIA requirement is also stipulated in Act Number 23 of 1997 concerning Management of the Environment and Government Regulation Number 27 of 1999 concerning EIA.

   b. The EIA is a study of the major and important environmental impacts of a planned business and/or activity as needed for the decision making process on the operation of the business and/or activity. The EIA findings are needed to ensure the viability of the project to be financed from an environmental standpoint. High impact activities conducted without an EIA may lead to harmful impact in the future because of lack of adequate planning for environmental management by the debtor and consequent lack of knowledge of the possible impacts of the business conducted by the

are not ….

debtor. This may then impact the business survival and capability of the debtor for repayment of the provision of funds. Furthermore, as stipulated in Government Regulation Number 23 of 1999, the EIA is one of the requirements that must be met to obtain licensing to conduct a business and/or activity.

c. The categories of planned business and/or activities requiring an EIA are stipulated in Decree of the State Minister for the Environment Number 17 of 2001 concerning Categories of Business or Activities Requiring EIA. This Decree may be reviewed on a periodical basis, normally every 5 (five) years. Matters pertaining to EIA for activities requiring an EIA can be seen on the Ministry of Environment website at www.menlh.go.id/amdalnet.

d. Environmental management is not only required at the commencement of a business activity, but must also be conducted by the debtor on a sustained, ongoing basis. To this end, the Ministry of Environment has launched the Corporate Performance Rating Program for Environmental Management (PROPER). Companies participating in PROPER are:

   1) companies with major impact on the environment;
   2) companies that cause pollution or damage to the environment on a large scale;

3) companies ….

3) companies that pollute and destroy the environment and/or could potentially pollute and destroy the environment;
4) public companies listed on the capital market, whether in Indonesia or overseas; or
5) export-oriented companies.

e. The results of the PROPER assessment will be aggregated into a number of ratings, namely gold, green, blue, red, and black. These results are regularly announced to the public and may be accessed at the Ministry of Environment website at www.menlh.go.id.

The meaning of each PROPER rating is as follows:

1) gold for business and/or activities that have pursued measures to control pollution and/or damage to the environment and/or implement clean production with excellent results;
2) green for business and/or activities that have pursued measures to control pollution and/or damage to the environment with results exceeding the requirements stipulated in the applicable laws and regulations;
3) blue for business and/or activities that have pursued measures to control pollution and/or damage to the environment with results meeting the minimum requirements stipulated in the applicable laws and regulations;

4) red ….

4) red for business and/or activities that have pursued measures to control pollution and/or damage to the environment but have not met the minimum requirements stipulated in the applicable laws and regulations;

5) black for business and/or activities that have not taken measures to control pollution and/or damage to the environment and which may cause pollution and/or damage to the environment;

III. QUALITY OF SECURITIES

In accordance with Article 14 of Bank Indonesia Regulation Number 7/2/PBI/2005, securities recognized at market value, not having reached maturity, and with coupons or other similar obligations paid promptly in the proper amount according to contract may be classified current insofar as the securities are actively traded on a stock exchange in Indonesia and there is transparent information on market value.

Quality of securities not meeting the criteria of actively traded on a stock exchange and/or lacking transparent information on market value as referred to above, or securities held to maturity, shall be assessed on the basis of rating of the securities as follows:

a. Current if:

   1) rated investment grade or higher;

2) coupons ….

2) coupons or other similar obligations are paid promptly in the proper amount according to contract; and

3) have not reached maturity.

b. Sub-standard if:

1) rated investment grade or higher;

2) have arrears in payment of coupons or other similar obligations; and

3) have not reached maturity,

or

1) are rated no lower than 1 (one) level below investment grade;

2) have no arrears in payment of coupons or other similar obligations; and

3) have not reached maturity.

c. Loss if the Securities fail to meet the criteria referred to in letter a and letter b.

Investment grade is rating as listed in Appendix II to this Circular Letter of Bank Indonesia.

For securities of Indonesian companies traded on leading overseas stock exchanges (at least on similar standing to a stock exchange in Indonesia), rating is defined as rating for securities traded on the overseas stock exchange or rating of relatively similar securities issued by the company and traded on a stock exchange in Indonesia or shall be based on

the provisions ….

the provisions for assessment of credit quality, if the company has not issued securities in Indonesia.

For securities that are by nature not actively traded on a stock exchange and are unrated, such as medium term notes and negotiation of export bills of exchange, classification of quality shall be based on the provisions for placement quality if the obligor is another Bank, or based on the provisions for credit quality if the obligor is not a Bank.

IV. PROVISION OF FUNDS TO SPECIFIED REGIONS

1. To strengthen the intermediary function and promote economic growth in specified regions, special treatment is extended in assessment of quality of provision of funds to debtors with business activities located in specified regions. The special treatment consists of easier requirements for Banks in assessment of quality, which shall be based solely on promptness in repayment of principal and interest
2. Provision of funds eligible for special treatment consists of credit and other provision of funds (comprising issuance of guarantee or opening of letter of credit) of up to Rp 1,000,000,000 (one billion rupiahs) for investment and/or working capital for debtors with business located in the following regions:
   a. North Maluku Province;
   b. Maluku Province;

c. West ….

c. West Irian Jaya Province;

d. Papua Province; and

e. Poso Regency in Central Sulawesi Province.

3. Assessment of quality of provision of funds in certain amounts to debtors with business activities located in Aceh Province and Nias Regency, including matters pertaining to debt restructuring, are stipulated in separate provisions.

V. ABANDONED PROPERTY

In accordance with Article 1 of Bank Indonesia Regulation Number 7/2/PBI/2005, abandoned property is defined as fixed assets in the form of property held by the Bank but not used for the customary business of the Bank. Customary business of a Bank includes property used to support the business of the Bank, insofar as the holdings are at a reasonable level, such as for office housing and property used for educational facilities, in addition to other property designated for use by the Bank in the course of its business in the near future.

VI. DEBT RESTRUCTURING

To minimize potential loss from problem debtors, Banks may take action that includes but is not limited to debt restructuring in the case of debtors that still have business prospects and will be able to meet obligations after restructuring of their debt. Banks are required to conduct debt restructuring in accordance with the applicable prudential principles, Financial Accounting Standards, and Guidelines for Bank Accounting in Indonesia.

1. General Guidelines for Debt Restructuring

   Banks are required to ensure that their lending guidelines are complete with written guidelines on debt restructuring that serve as a guide to the procedures and steps necessary in conducting debt restructuring. The debt restructuring guidelines shall state at least the following:

   a. Analysis and documentation

      In analyzing the credit to be restructured, Banks shall give attention to at least the following:

      1) Evaluation of debtor issues and problems with scope as follows:

         a) evaluation of causes of arrears in principal and/or interest based on the financial statement, cash flow, financial projection, market conditions, and other factors pertaining to the business of the debtor.

         b) estimated repayment of the entire loan principal and/or interest based on the credit agreement prior to and after debt restructuring. This estimate should be based on financial ratios, including projections of these ratios, that reflect the

financial ….

financial condition of the debtor and the capability of the debtor to repay the debt.

c) evaluation of debtor management performance to determine the need for organizational restructuring of the debtor company, including but not limited to replacement of shareholders, board of directors, and other managerial changes. If necessary, the Bank may seek assistance from external technical experts to conduct the organizational restructuring. If the debtor is an individual debtor, new additional collateral or guarantee must be required.

2) The approaches and assumption used in determining the projected cash flows of the debtor and in calculating present value of principal installments and/or interest to be received.

3) Analysis, conclusions, and recommendations concerning adjustments to the terms and conditions of the credit, such as reduction in interest rate, reduction in arrears in principal and/or interest, amendment of tenor, and/or additional facility. These adjustments shall take into account the business cycle and repayment capability of the debtor to enable the debtor to meet obligations for repayment of principal installments and/or interest through maturity.

4) If debt ….

4) If debt is restructured by provision of additional credit, the purpose and use of the additional credit must be clear. The additional credit may not be used for repayment of loan principal and/or interest.

5) Adjustment to the repayment schedule reflects the repayment capability of the debtor.

6) Details pertaining to the terms and conditions of the credit, including the financial terms of the loan agreement, among others any plan for recapitalization of the debtor company or clause enabling the Bank to raise the interest rate in line with the repayment capability of the debtor.

7) Details of the accompanying documentation necessary to the operation of the debt restructuring.

8) Requirement that the loan agreement and other documents pertaining to operation of the debt restructuring must be legally enforceable.

b. Monitoring procedure

Banks are required to have written procedures for monitoring restructured debt to ensure that debtors have the commitment and ability to execute repayment in accordance with the terms and conditions of the new loan agreement.

These …

Actions that must be taken for monitoring purposes include but are not limited to the following:

1) preparation of monthly report on the business progress of the debtor, stating details of business progress, implementation of the action plan, and likelihood of repayment.

2) requirement for the debtor to submit financial statements complete with key financial ratios as needed by the Bank to monitor the business and financial condition of the debtor on an ongoing basis. The debtor shall also be required to report the impact of various actions taken as part of the debt restructuring, such as recapitalization of the debtor company and any decision not to pay out a dividend.

3) formulate actions to be taken if the debtor continues to experience difficulty in repayment after debt restructuring.

2. Guidelines for Accounting Treatment for Debt Restructuring

   Accounting treatment for debt restructuring shall be implemented in accordance with the applicable Financial Accounting Standards and Guidelines for Bank Accounting in Indonesia, with attention to the following:

   a. The method used in calculating new net book carrying value shall be based on the following order of priority:

1) present …

1) present value of expected cash flows in accordance with the value of the restructured debt, using a discount rate; or
2) market value of the restructured debt, insofar as the value is available; or
3) collateral value, if repayment of the credit is heavily dependent on collateral.

b. In calculating the present value of expected cash flows from restructured debt, the Bank must use the effective rate of interest of the credit prior to restructuring as the discount rate. If the loan agreement prior to restructuring applies a variable interest rate, the Bank may use an interest rate reflecting the variable interest rate, among others by using the interest rate in effect at the time of debt restructuring.

c. If the new net book carrying value under one of the methods of calculation in letter a is lower than the balance of credit prior to restructuring, the Bank shall treat the difference as loss. This loss shall be charged after taking into account any excess Provision for Asset Losses formed by reason of improvement in credit quality after restructuring.

d. After deduction for losses incurred in the debt restructuring, any excess Provision for Asset Losses formed by reason of improved quality of restructured credit may only be recognized as revenue

after …

after receipt of principal installments on the restructured debt. Revenue shall be recognized pro rata according to the receipt of principal installments on the restructured debt.

e. In calculating expected cash flows from restructured debt for calculation of present value as referred to in letter a, the Bank shall apply reasonable assumptions in accordance with current developments to ensure that the projection is realistic.

f. If the debt restructuring is conducted wholly by transference of assets, including securities, or conversion of credit to temporary equity participation, recognition of loss shall be recorded at the difference between market value of the assets or equity received and book value of the credit.

g. If part of the debt is restructured by transference of assets, including securities, or conversion of credit to temporary equity participation, and part of the debt is restructured by modification of the terms and conditions of the credit, recognition of loss shall be recorded at the difference between market value of the assets or equity received and book value of the credit and recognition of loss from modification of the terms and conditions of the credit shall be according to the provisions referred to in letter a.

h. Loss from restructuring of Small-scale Business Credit and consumption credit may be calculated according to the type of credit using the statistical method or by appraisal of each credit facility in accordance with the provisions in letter a, letter b, letter c, letter d, and letter e.

i. The Bank must evaluate restructured debt each quarter. In the event of any significant differences between projection and outcome in principal installments and interest, term, cash flow, interest rate, or appraised collateral value, the Bank shall recalculate the loss incurred.

VII. REPORTING

1. Banks are required to report all debt restructuring undertaken to Bank Indonesia no later than 10 (ten) working days after the end of the reporting month, using the debt restructuring reporting form as per Appendix III to this Circular Letter of Bank Indonesia.
2. Reports as referred to in number 1 shall be submitted to Bank Indonesia at the following addresses:
   a. relevant Directorate of Bank Supervision, Jl. MH. Thamrin No. 2, Jakarta 10110, for a Bank having its head office in the working area of the Bank Indonesia head office;
   b. the local Bank Indonesia Regional Office, for a Bank having its head office outside the working area of the Bank Indonesia head office.

VIII. CONCLUDING …

VIII. CONCLUDING PROVISIONS

1. With the issuance of this Circular Letter of Bank Indonesia:
   a. Circular Letter of Bank Indonesia Number 31/10/UPPB dated November 12, 1998, concerning Earning Asset Quality and Circular Letter of Bank Indonesia Number 31/11/UPPB dated November 12, 1998, concerning Formation of Allowance for Earning Asset Losses are revoked and declared no longer valid.
   b. Circular Letter of Bank Indonesia Number 31/12/UPPB dated November 12, 1998, concerning Debt Restructuring is declared no longer valid for Commercial Banks conducting conventional business.
2. The appendices referred to above constitute and integral part of this Circular Letter of Bank Indonesia.

The provisions in this Circular Letter of Bank Indonesia shall come into force on January 31, 2005.

For the public to be informed, it is ordered that this Circular Letter of Bank Indonesia be promulgated in the State Gazette of the Republic of Indonesia.

Kindly …

Kindly be informed.

BANK INDONESIA,

MAMAN H. SOMANTRI
DEPUTY GOVERNOR